No. 15,645

United States Court of Appeals

For the Ninth Circuit

HAROLD M. KOCH, BESSIE KOCH, WILLIAM L. KOCH, ROSE KOCH, REBECCA KOCH ABEL, MAURICE P. KOCH, and DAISY KOCH,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

On Appeal from the United States District Court for the Northern District of California.

APPELLANTS' PETITION FOR A REHEARING.

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To the Honorable Judges of the United States Court of Appeals for the Ninth Circuit:

Appellants, on the grounds following, petition for a rehearing of the Court's judgment affirming the judgment of the District Court for the Northern District of California.

I.

THIS HONORABLE COURT HAS OVERLOOKED A WELL SETTLED PRINCIPLE OF LAW SUPPORTED BY CONSISTENT AUTHORITIES, AND ITS OPINION THREATENS EMBARRASSMENT AND CONFUSION IN THE AUTHORITIES.

The rule regarding the effect of the presumption of correctness of determinations by the Commissioner of

Internal Revenue in the trial of tax causes has been well settled. The presumption disappears upon the introduction of evidence, and the issues are then tried, determined and depend *wholly upon the evidence produced.* The presumption cannot be considered when weighing the evidence. The presumption is *no longer existent* after the introduction of evidence, and *cannot affect the burden of proof.* When evidence has been introduced, the cause must be decided *upon the evidence alone.*

Appellants cited established authority, and particularly the decisions of this Court, in the cases as follows:

In the case of *Hemphill Schools v. Commissioner of Internal Revenue,* 137 F. 2d 961, C.C.A. 9 (1943), at pp. 963, 964, this Honorable Court reversed and remanded the cause for trial with the direction that the trial body: "(1) Find from the evidence, and from it alone . . ."

In that case this Court stated:

> "Thus, if no evidence had been produced, the Board would have had to accept the determination; for, until evidence was produced, the determination was presumed to be correct. *Evidence was produced.* Some of the evidence produced by the petitioner tended to prove that its gains and profits were not permitted to accumulate beyond the reasonable needs of its business. Evidence having been so produced, *the presumption ceased, and thenceforth the issue depended 'wholly upon the evidence.'* It thus became the duty of the Board to find *from the evidence, and from it*

alone, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the *presumption (which no longer existed) as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it.*

"Decision vacated and case remanded, with direction to (1) find from the evidence, *and from it alone,* whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business." (Emphasis ours, as well as this Court's in certain instances.)

Appellants also cited this Court's decision in the case of *San Joaquin Brick Co. v. Commissioner of Internal Revenue,* 130 F. 2d 220, C.C.A. 9 (1942), at p. 225:

"But once he presents competent and relevant evidence on every necessary element, the presumption of correctness of the Commissioner's determination *is no longer existent* and the outcome of the case depends upon the determination of the trial body after the consideration of the evidence brought before it by both sides." (Emphasis ours.)

Appellants also cited this Court's decision in the case of *J. M. Perry v. Commissioner,* 120 F. 2d 123 (1941) C.C.A. 9:

"This finding is presumptively correct, that is, until the taxpayer proceeds with competent and relevant evidence to support his position, the determination of the Commissioner stands. When

> such *evidence* has been adduced the issues depend *wholly* upon the evidence so adduced and the evidence to be adduced by the Commissioner. *The Commissioner cannot rely upon his determination as evidence of its correctness either directly or as affecting the burden of proof.*" (Emphasis ours.)

In *Lawrence v. Commissioner of Internal Revenue* (1944) (9th C.C.A.), 143 F. 2d 456, this Court held that the presumption disappears when evidence is introduced sufficient to establish a prima facie case.

On September 12, 1958, this Honorable Court filed its opinion, in contravention of all prior decisions cited, and without reviewing or considering the same, the opinion states (on the last page) as follows:

> "Appellants also object to an instruction on the ground that the presumption that the administrative determination that the partnership was not engaged in a trade or business was given *too much weight*. Appellants admit that there is such a presumption but *claim* it vanishes when evidence is produced."

Thus this Court has erroneously overruled all authorities upon the subject which clearly hold that the presumption disappears completely upon the introduction of evidence, and is no longer existent following the introduction of evidence. The authorities have determined that under no circumstances may the presumption be considered as evidence when actual proofs are made; that under no circumstances may the presumption preponderate over evidence adduced during trial. All previous authority on the subject has now been discarded by this Court with the statement that

appellants "claim" such a rule, and that the matter has a relationship to the *amount* of "weight."

By its failure to approve the respectable authority upon the subject, and its erroneous view of this cause, this Honorable Court has done away with the basic concept of the trial of all tax causes. We now have injected into the field of jurisprudence and fair trial, the concept that the one who is sued may, by his own self-serving declaration, establish evidentiary values which may preponderate over actual evidence adduced during trial. Thus a rule of "going forward" has been vicariously catapulted into the realm of evidentiary values which may preponderate over actual evidence adduced during trial. See *Redfield v. Eaton* (D.C.) (1931), 53 F. 2d 693, 696, which states:

> "But that the Commissioner's decision, resting on evidence not presented to the Court—in this case the defendant offered not a single witness—has the quality of probative evidence in determining the preponderance of evidence, is a proposition supported neither by authority nor reason."

In the instant cause, just as in *Redfield v. Eaton,* supra, the defendant offered not a single witness, and in fact no evidence of probative value, and rested entirely on the presumption, which in turn was based upon nebulous considerations made outside of Court.

In giving such effect to the extrajudicial determination and self-serving declaration of the Commissioner of Internal Revenue, the trial Court, and now this Honorable Court have denied to appellants due process of law and a fair trial.

In the last paragraph of its decision, this Court repeats a portion of the instruction given as follows:

> "The burden is upon the plaintiff to overcome the presumption of the correctness of the Commissioner's determination by proving by a preponderance of the evidence that they were engaged in a trade or business of financing motion pictures."

This instruction clearly stated that the presumption affects the burden of proof; that a prima facie case is not a sufficient showing; that the presumption must be weighed with evidence opposing it; that the presumption continues during and throughout the determination and weighing of the cause and the evidence produced at trial.

The last sentence of the opinion is indeed shocking. Just prior to its appearance this Court reprints the portion of the instruction which states, in crystal-clear language, that the burden is upon plaintiffs to overcome the presumption by a preponderance of the evidence. The final sentence in the opinion nevertheless states:

> "The instruction did not specifically state that the presumption was to be considered as evidence and the burden of proof of plaintiffs was correctly explained."

We were surprised to find the quoted language in appellee's brief, and we are now completely devastated to find it in the final words of this Honorable Court. Obviously, the instruction states that the burden is

upon the plaintiffs to overcome the presumption by evidence which preponderates over it.

This Honorable Court cannot now announce, without violence to concepts of law, that "the burden of proof of plaintiffs was correctly explained."

If this decision is permitted to remain without change, it would create chaos in the trial of tax causes, because:

(a) The clear rule enunciated by this Court on several occasions and the accepted and prevailing rule is now shrouded and overruled.

(b) Should trial Courts instruct the jury as to the "weight" to be given to the presumption, despite the previously prevailing rules that the presumption "disappears"; that it cannot "affect the burden of proof"; that "the presumption ceased"; that the issue depends *wholly* upon the evidence"; that the duty is to find "from the evidence, and from it alone"; that after the introduction of evidence the presumption "no longer existed"; that it is error to have "weighed it against petitioners' evidence"?

The Government did not call a witness, and its defense was based entirely upon the alleged presumption. Meticulous examination of the record reveals absolutely no testimony or evidence upon which a defense could be predicated in the absence of such alleged presumption.

The trial Court made its findings of fact and drew its conclusions of law based upon the erroneous concept that the presumption persisted, and ruled

throughout the trial, during argument, in its instructions, in its conclusions of law, and in its judgment, that the *presumption* persisted. The entire determination was based upon this erroneous view.

The presumption was the central issue in the case. The trial and determination of the cause was controlled by this erroneous concept.

This Court must recognize the violent effect of the last words of its decision, which states that "the burden of proof of plaintiffs was correctly explained."

It is not for the Appellate Court to determine the weight of the evidence. If we deduct from the scales the effect of the *presumption,* it is probable that the trier of facts would determine that the evidence favoring the taxpayer's position outweighs or is more convincing than the evidence opposed to it (there being none). The devastating effect of the erroneous use of the presumption when fortified by the Government's final emotional appeal "we submit to you, ladies and gentlemen, the finding of the Commissioner of Internal Revenue, who was a duly and legally appointed executive officer of the Government, sworn to administer Internal Revenue Laws . . ."; (R. 371) and the further argument (over objection) that "plaintiffs have already had one crack at the case" (R. 344), cannot be ignored by this Honorable Court. This error pervaded each and every determination in the trial Court, and set up a false barrier of such magnitude that the same could not be overcome.

THE PARTNERSHIP AGREEMENT WAS ERRONEOUSLY CONSTRUED BY THIS COURT.

The partnership agreement, construed within its four corners (appellants' opening brief appendix B), provides "The said partnership business will, . . . engage in the business of financing motion picture productions". The basic agreement (appellants' opening brief appendix A) provides . . . "all of said parties shall devote all of their time to the interest of said business and for the benefit thereof . . ." and further provides for forfeiture of the partnership interest if this provision is breached.

Although the partners could contribute disproportionate amounts, all such contributions are covered by the partnership agreement; the same are subject to disbursement under the partnership agreement; the same became assets of the partnership; the same are in each and every respect controlled by the partnership and by the partnership agreement; and each and every act of the partners in this connection is on behalf of the partnership.

This Honorable Court has misconstrued the partnership agreement and has stated "the partnership agreement seems to contemplate loans and other activities of the individual partners". This is diametrically opposed to a proper construction of the partnership agreement.

THE OPINION OF THIS HONORABLE COURT IS REPLETE WITH MISTAKES REGARDING THE FACTS OF RECORD.

Most glaring is the constant repetition in the decision that the appellants were engaged in the business

of loaning money; whereas the record demonstrates that the activities were designed to promote and finance the pre-production "phases" (or the so-called "packaging") of film productions. Appellants desired to obtain as large a participation and ownership in each film venture as possible and advanced funds only to the extent necessary to obtain such interests. Their activities were limited to so-called "front money" (R. 226, 227) for the purpose of forming the corporation and acquiring the rights to literary properties, artistic talents and facilities (R. 40, 42, 196, 226, 227, 229, 230). They did not finance production during principal photography of films. Their efforts were devoted to assembling the corporate vehicle, stories, artistic talent, facilities and other funds necessary to production. The decision erroneously recites and repeats that they were trying to make loans.

Their continuous expenditures of valuable time, money and effort is now erroneously described in the opinion as follows: "The record is replete with activities of Maurice P. Koch consisting of telephone calls, conversations, discussions and airplane journeys"; and the opinion also states: ". . . we do not think the jury could conclude that a number of futile transactions and activities looking toward consummation of loans had *any value* in determining whether the partnership was engaged in the business of financing." (Emphasis ours.)

We are constrained to observe that this Court has knowledge of the difficulties inherent in "packaging" artistic talents, facilities and the enormous sums re-

quired for production of films, and the inherent requirements of time, energy and funds to the purpose of bringing about a merger, at the same time, of all the necessary ingredients to the production of a major motion picture in the so-called "independent" field.

Also in error is the statement: "Sebastian and Hersch repaid the $10,000 loaned upon the sale of the first picture". This $10,000 was not loaned; it was not repaid; and it was lost. This error in the concept of facts indicates complete misunderstanding by this Court of the facts of this case. The sum of $15,000 was delivered by appellants to David Sebastian. $5,000 of this sum was used by Sebastian on behalf of appellants for the expenses of organizing the affairs of Beacon Pictures. $10,000 of this sum was used to buy the stock of Beacon Pictures in the name of one Coslow, which stock had to be in Coslow's name in order to obtain distribution through United Artists (Plaintiffs' No. 5 for identification, appendix D, appellants' opening brief) (R. 50-53, 250-252). Said Exhibit 5 was erroneously excluded by the trial Court. The opinion should correctly recite that appellants caused Beacon Pictures to be organized, and caused its properties, talents and facilities to be assembled, and that appellants expended sums for that purpose in addition to their efforts.

Despite the fact that the partnership put up the money and did everything to get this project started, the opinion recites erroneously ". . . but the partnership did not engage in the organization of such corporation" (Beacon).

Obviously, the $10,000 in capital stock issued to Sam Coslow did not establish capital of any meaning when considered in the light of obligations totaling $1,400,000.00 incurred in the production of the film. The opinion should clarify that the amounts advanced as so-called "loans", were in reality funds which could only be realized, if at all, from the success of the venture or syndicate.

This Court has also overlooked the fact that appellants were engaged in the business of "packaging" film productions for more than three years prior to the year in question, and continued to engage in the same for some years following the year in question. The opinion overlooks the salient fact that all of plaintiffs' available funds became frozen in the year 1947 in the unfortunate film called Copacabaña, and that the freezing and loss of these funds prevented the conclusion of the many pending negotiations. The opinion is also erroneous in concluding that Maurice Koch advanced funds to Apex Films, when in fact the funds were advanced by the partnership as well as by and through Producers Finance Corporation which was organized solely by the partnership for that purpose (R. 173-4).

This Court likewise erroneously concluded that a directed verdict was granted as against Maurice Koch when, in fact, the Court merely eliminated his claim based upon the loss of $15,000 more than the amounts lost by the other partners, which ruling is contrary to the issues framed by the pleadings which admit the loss of the entire sum of $90,000, including

the additional $15,000 loss sustained by Maurice Koch. Just how the trial Court arrived at a finding that only $75,000 was lost despite the plain facts, the issues as framed by the pleadings, and the realities of the situation will continue to remain a mystery which we fervently hoped would be resolved by this Court. The trial Court refused to hear from appellants upon the subject.

THE RULE ANNOUNCED BY THIS HONORABLE COURT REGARDING CONSIDERATIONS TO BE GIVEN TO ACTIVITIES OF THE TAXPAYER IN DETERMINING WHETHER OR NOT ONE IS ENGAGED IN A PARTICULAR BUSINESS IS IN CONFLICT WITH THE PREVAILING LAW PROMULGATED AND APPROVED BY THE SUPREME COURT AND ALL OF THE CIRCUITS.

Note: We have mentioned that appellants were not in the business of making "loans", and that this Honorable Court is in error in stating that appellants made only one isolated "loan at the outside," when in fact appellants were constantly engaged during the entire year 1947 in "packaging" films and expended time, energy and funds consistently during said year for that purpose. We also note that this procedure continued prior to, as well as following the year in question.

In view of the peculiar facts of the case and the arguments and contentions made at the time of trial, appellants requested several instructions to the effect that time and effort expended for the purpose of advancing appellant's projects should be considered by

the triers of fact, and should be considered whether or not the same resulted in completed productions.

An appeal was taken to this Court upon the failure of the trial Court to instruct upon the subject as requested (see App. Op. Br. pp. 10 and 11; R. 23 to 26) and for the purpose of having the rule clearly enunciated that all activities of the taxpayer, including all time, all efforts and all funds expended in advancing the taxpayers' projects should be considered in determining whether or not the taxpayer is engaged in a particular trade or business.

This Court has announced its views upon that subject; however, these views are in conflict with prevailing authority. Prevailing authority upon the subject (see footnote 5, p. 40, appellants' opening brief) has established that all activities must be reviewed and considered. The decision of this Court on p. 5 states:

> "Where appellant had made only one isolated loan at the outside, we do not think the jury could conclude that a number of futile transactions and activities looking toward consummation of loans had any value in determining whether the partnership was engaged in the business of financing."

Thus this Court has held that activities which do not result in concluded transactions have no value in determining whether a taxpayer is engaged in a particular business.

The decision of this Honorable Court holds that only activities relating to completed transactions may be considered in this vital determination.

We find no authority for the proposition that only concluded transactions, or that only fully produced film productions, or that only efforts expended upon concluded transactions may be considered in determining whether or not one is engaged in a business. No consideration is afforded the taxpayer who has devoted his time, effort, energy and substance when only one, or a very few, transactions are successfully culminated.

We note that that there are many large enterprises such as the independent film business, where numerous efforts result in but very few concluded transactions. Certainly, only concluded transactions are not fully probative of the time, effort, energy and substance expended.

WHEN PERSONS FORMALLY AGREE TO ENGAGE IN A PARTICULAR BUSINESS AND ACCORDINGLY PROCEED TO ACT UNDER THE AGREEMENT, FURTHER INQUIRY IS IMPROPER.

We note that here the taxpayers solemnly agreed by formal agreement to engage in the business of financing motion picture ventures some three years prior to the period in question; that they acted thereunder prior to the time in question, during the time in question, and after the time in question. There was no suggestion of fraud, and the Court actually found that their agreement was at all times in full force and effect.

In the absence of specific agreements the Courts have resorted to a consideration of the activity of the

persons involved in order to determine the amount of time, efforts, energy and funds expended for the purpose of establishing the fact in question by overt acts. When parties have stipulated their intentions in formal writing and have agreed and acted accordingly, it would appear erroneous to permit inquiry having far less probative value and not necessarily related to the particular act or transaction in question. Thus, if persons agreed formally to engage in the building business and actually built a building, why should Courts look further to establish the clear intent and purpose of the parties? We suggest that any rule which contravenes the formally expressed purpose, intent and act of the parties and permits inquiry into secondary evidence and *res inter alios acta,* should not be acceptable to this Honorable Court.

THIS COURT HAS ERRONEOUSLY HELD THAT THE BUSINESS OF FINANCING IS NOT A TRADE OR BUSINESS.

Cases have been decided upon the peculiar facts of each case; however, there is no authority for the rule now announced by this Court that the business of financing, under a "common sense view", is not a trade or business.

This Court has stated:

> "It may be that the jury took a common sense view and refused to recognize investment, management and other forms of financing as a trade or business."

The view, thus expressed, is inherently incorrect in fact as well as in law. It seems well settled that any

activity may be or become a business if conducted as a business. Financing is certainly no exception and has been a well-recognized basic business since the beginning of known civilization.

The pronouncement by this Court of a rule that financing, under a "common sense view", may not be regarded as a trade or business will create unexpected confusion in the law.

ERRONEOUS RULINGS RE REJECTION OF EVIDENCE HAVE NOT BEEN CONSIDERED BY THIS HONORABLE COURT, AND RULINGS CONSIDERED HAVE BEEN DETERMINED IN ERROR, BOTH IN LAW AND IN FACT.

The most cogent inquiry involved the amount of time spent in connection with motion picture activities. The trial Court excluded testimony offered to prove the amount of time spent during the year in question (R. 2, R. 60; R. 245-246).

Numerous documents were presented and refused upon the ground that the same were not executed. Those that were executed, and due execution proved, were excluded on the ground that the name of appellants did not appear therein (R. 46, 210-212, 213-214, 78-85, 84-85, 99-100, 78, 88-89, 109, 124, 128-130, 92-93).

The opinion of this Court states:

> ". . . the documents did not prove anything with regard to appellants. They were properly excluded."

These documents tended to prove the time, efforts, energies and funds expended in negotiation and in

packaging motion picture financing transactions. They are the various documents which tangibly demonstrate the various packaging efforts for each of the artistic elements, facilities, distribution of films, and financing. These are the ingredients which must be obtained, all at the same time, in order to make a film, and the record clearly demonstrated that it would be senseless to execute one agreement, for only one of the elements, unless all were available at the same time. The problem is inherent in the nature of independent film production.

The documents were not offered to prove the truth of their content. They were offered to show the time and effort expended, and further to show the intention of the partnership as indicated by the overt acts of negotiation which resulted in the documentation. The Court and jury could have reasonably drawn from these documents inferences supporting plaintiffs' position that time and negotiations continued and that funds were expended in such negotiations as well as in the drafting of the documents.

It was clear that the documents were offered for the purpose of proving activity, and not to prove that particular transactions were concluded. Of course, if the rule now announced by this Court in its present opinion should stand, efforts, negotiations, expenditures of time and all of their substance expended by these partners become meaningless; however, we fervently hope that this Honorable Court will reappraise its opinion in this regard.

CONCLUSION.

We respectfully submit:

(1) that all causes, including the instant one, should be tried upon the basis of appropriate legal criteria;

(2) that the opinion filed by this Court will create confusion with regard to generally accepted principles prevailing in tax trials; and

(3) that the matter must be reconsidered and the opinion and decision of this Court revised.

We respectfully request that in the event appellants' petition for rehearing is denied, this Honorable Court permit hearing of this cause en banc in order that appropriate criteria respecting the trial of tax causes may be fully considered by this Court, and in order that appropriate instructions and rules of evidence may be applied for the benefit of litigants in such causes.

Dated, San Francisco, California,
October 10, 1958.

Respectfully submitted,
MAX FINK,
LEON SCHILLER,
Attorneys for Appellants and Petitioners.

CERTIFICATE OF COUNSEL.

Counsel in this cause certify that in their judgment the grounds stated in this petition for rehearing are well founded, and this petition for rehearing is not interposed for delay.

Dated, San Francisco, California,
October 10, 1958.

MAX FINK,
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Attorneys for Appellants and Petitioners.